

FDIC State Profile

Spring 2005

Arizona

Arizona reported a healthy 3.9 percent year-over-year job growth rate in fourth quarter 2004 (ranking second best nationwide) and is expected to remain strong in 2005.

- The construction sector reported gains of more than 16,000 new jobs during 2004 (See Chart 1). Although this sector accounted for less than 10 percent of the state's labor force, it created a disproportionately high share of new jobs during the past year. In addition, job growth in related sectors, such as financial services and retail trade (in home improvement categories), was strong but may be vulnerable if construction activity slows as interest rates rise.
- Arizona's government sector reported significant job gains, particularly in the **Phoenix** metropolitan area; trends are likely to continue as strength in the state's budget was forecast for fiscal year 2006.
- Arizona's manufacturing sector continued its recovery, and the aerospace subsector added jobs during the quarter.

Housing permit growth may moderate price gains.

- Residential permit issuance was quite strong in Arizona during 2004; in aggregate, the state's measure of permits per 1,000 capita was more than twice the national rate. Activity was particularly brisk in **Pinal** and **Mohave** counties where per-capita permit issuance was seven and three times the national rate, respectively.
- Going forward, residential permit issuance in Arizona is expected to moderate according to the **Western Blue Chip** consensus forecast, which predicts that 2005 permit volume will be about 3.4 percent lower than the 2004 level.
- Home price growth in Mohave County (adjacent to Las Vegas, NV where year-over-year price gains are highest nationwide) now tops the state, and the year-over-year gains were nearly four times the Arizona average. Price gains may not be sustainable, however, if new housing supply is not matched by similar demand growth.
- While residential mortgage portfolio growth during 2004 raised the median concentration of 1-4 family mortgages to 89 percent of Tier 1 capital, concentrations remained modest in relation to other states. Insured institutions are

Chart 1: All Major Sectors Except Information Added Jobs in Arizona During 2004

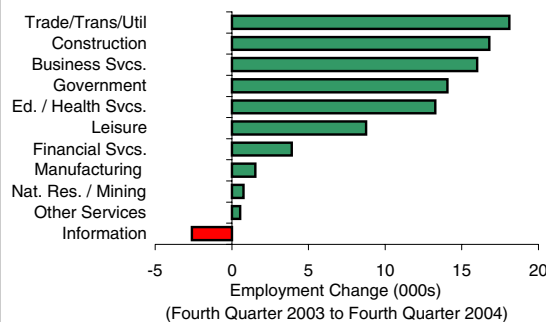


Chart 2: Phoenix Office, Industrial, and Multi-Family Markets Can Expect Strong Absorption Into 2006

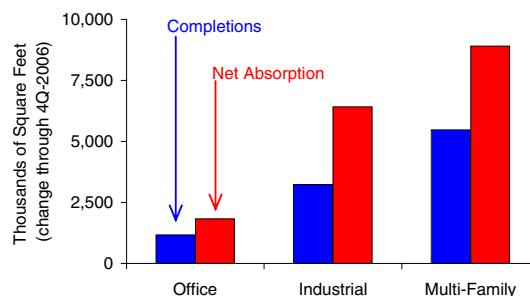
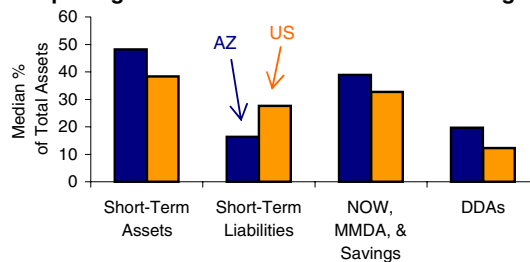


Chart 3: Arizona-Based Banks Report Short Asset Repricing Intervals and Less Sensitive Funding



also exposed to housing markets through high construction and development (C&D) loan portfolios, which represented 140 percent of Tier 1 capital on a median basis, the highest concentration among the states.¹

- Arizona-based insured institutions reported one of the lowest past-due rates for 1-4 family mortgages nationwide, but some reports suggest that speculative activity may be on the rise, making home prices and defaults susceptible to rising interest rates.²

Commercial real estate (CRE) conditions strengthened.

- Strong job and population growth contributed to improving conditions in the Phoenix office, industrial, and multi-family markets. Absorption is expected to outpace new completions through 2006, resulting in a decline in vacancy and availability rates (See Chart 2).
- The **Tucson** outlook is also positive; the office vacancy and industrial availability rates are expected to moderate during the next two years.
- Arizona-based insured institutions reported a median concentration of CRE loans to Tier 1 capital of 462 percent.³ Although concentrations are high, past-due CRE ratios continued to decline, a trend likely facilitated by the low interest rate environment and rapid loan growth. However, CRE borrowers remain vulnerable to rising interest rates since it raises debt service costs.

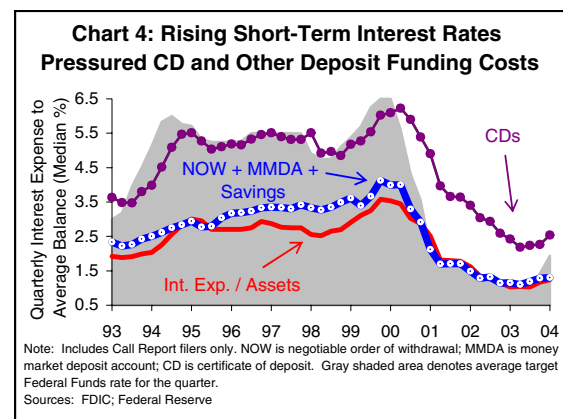
Earnings improved and asset quality was strong.

- The median year-to-date return on average assets increased from 0.88 to 0.99 percent, buoyed primarily by widening net interest margins (NIMs) and declining overhead and provision expense burdens. Earnings trends reflect the high proportion of young but maturing insured institutions. NIMs benefited from both rising interest rates and increasing loan-to-asset ratios, which reached 76 percent on a median basis by year-end 2004, the highest ratio nationwide.
- Arizona-based insured institutions reported the second fastest median loan growth rate among the states, driven in part by the high proportion of young institutions. Loan growth also may have helped moderate past-due loan ratios. During 2004, loan loss provision expenses kept pace with low problem loan volumes, but not overall loan growth. Consequently, the median loan loss reserve-to-total loan ratio fell to 1.06 percent. Interest

rate increases and portfolio seasoning may lift loan default activity and pressure provision expenses prospectively.

Despite rising funding costs, margins expanded.

- NIM expansion, which began in late 2004, may continue in 2005 as asset yields respond to rising interest rates at a faster pace than funding costs. Arizona-based banks reported high exposures to assets that mature or reprice in 2005; banks also may benefit from funding structures that have historically been less sensitive to interest rate shifts (See Chart 3).
- In late 2004, quarterly interest expense ratios among Arizona-based banks increased modestly in tandem with rising short-term interest rates, a trend that is expected to continue as deposit pricing incorporates recent and anticipated short-term interest rate hikes.
- More than half of insured institutions based in Arizona reported exposure to brokered deposits, up from 17 percent five years ago. Among users, brokered funds typically supported more than 7 percent of assets. These deposits require competitive pricing and likely would be very sensitive to changes in interest rates.
- However, an above-average reliance on low and no-cost checking and savings accounts may soften the effect of rising interest rates on overall interest expense ratios. NOW, MMDA, and savings accounts funded 39 percent of Arizona bank balance sheets on a median basis, and the median demand deposit account-to-total asset ratio of nearly 20 percent among Arizona-based banks ranked third among the states.⁴ These sources of funding have traditionally been less sensitive to short-term interest rate hikes than certificates of deposit (See Chart 4).



¹Although quarterly reports filed by insured institutions do not distinguish between commercial and residential C&D loans, anecdotal reports suggest a portion of C&D exposures relate to home building.

²"Foreclosures.com: Auctions and Speculators Continue to Increase in Phoenix Metro", Business Wire, February 28, 2005.

³CRE includes construction, multifamily, and nonfarm-nonresidential mortgages.

⁴NOW is negotiable order of withdrawal (an interest-bearing checking account with restrictions); MMDA is money market deposit account (an interest-bearing savings vehicle with limited check-writing privileges).

Arizona at a Glance

ECONOMIC INDICATORS (Change from year ago quarter, unless noted)

Employment Growth Rates	Q4-04	Q4-03	Q4-02	Q4-01	Q4-00
Total Nonfarm (share of trailing four quarter employment in parentheses)	3.9%	2.0%	1.1%	-0.7%	3.2%
Manufacturing (7%)	0.9%	-2.5%	-7.4%	-8.7%	1.7%
Other (non-manufacturing) Goods-Producing (8%)	9.3%	4.2%	-0.1%	-0.2%	4.3%
Private Service-Producing (67%)	3.7%	2.9%	1.8%	-0.9%	3.4%
Government (17%)	3.5%	-0.4%	3.1%	4.0%	3.0%
Unemployment Rate (% of labor force)	4.6	5.3	6.0	5.5	3.9

Other Indicators	Q4-04	Q4-03	Q4-02	Q4-01	Q4-00
Personal Income	N/A	6.7%	3.2%	3.9%	8.2%
Single-Family Home Permits	8.2%	22.0%	31.2%	0.8%	-3.2%
Multifamily Building Permits	-21.8%	18.9%	131.1%	-48.6%	-29.3%
Existing Home Sales	28.8%	9.6%	21.0%	5.2%	1.8%
Home Price Index	14.5%	7.4%	5.9%	6.3%	6.4%
Bankruptcy Filings per 1000 people (quarterly level)	1.21	1.30	1.36	1.23	0.98

BANKING TRENDS

General Information	Q4-04	Q4-03	Q4-02	Q4-01	Q4-00
Institutions (#)	49	50	46	46	49
Total Assets (in millions)	59,322	60,773	48,888	44,220	62,655
New Institutions (# < 3 years)	10	13	13	12	16
Subchapter S Institutions	7	6	3	2	1

Asset Quality	Q4-04	Q4-03	Q4-02	Q4-01	Q4-00
Past-Due and Nonaccrual Loans / Total Loans (median %)	0.37	0.56	0.44	1.19	0.81
ALLL/Total Loans (median %)	1.06	1.17	1.19	1.30	1.29
ALLL/Noncurrent Loans (median multiple)	3.46	3.34	4.14	1.72	2.87
Net Loan Losses / Total Loans (median %)	0.00	0.03	0.12	0.04	0.01

Capital / Earnings	Q4-04	Q4-03	Q4-02	Q4-01	Q4-00
Tier 1 Leverage (median %)	10.27	9.90	9.59	9.25	9.20
Return on Assets (median %)	0.99	0.88	0.83	0.87	1.12
Pretax Return on Assets (median %)	1.15	1.16	1.22	1.10	1.34
Net Interest Margin (median %)	5.09	4.66	4.74	5.11	5.49
Yield on Earning Assets (median %)	6.26	5.98	7.01	8.38	9.15
Cost of Funding Earning Assets (median %)	1.28	1.30	2.10	3.34	3.84
Provisions to Avg. Assets (median %)	0.17	0.28	0.28	0.35	0.33
Noninterest Income to Avg. Assets (median %)	0.63	0.70	0.77	0.71	0.66
Overhead to Avg. Assets (median %)	3.69	3.76	4.28	4.46	4.49

Liquidity / Sensitivity	Q4-04	Q4-03	Q4-02	Q4-01	Q4-00
Loans to Assets (median %)	76.4	69.4	69.1	70.2	68.0
Noncore Funding to Assets (median %)	15.7	15.3	17.4	17.5	14.9
Long-term Assets to Assets (median %, call filers)	5.2	7.8	8.4	9.8	6.4
Brokered Deposits (number of institutions)	26	21	20	15	13
Brokered Deposits to Assets (median % for those above)	7.2	7.1	10.1	17.9	5.5

Loan Concentrations (median % of Tier 1 Capital)	Q4-04	Q4-03	Q4-02	Q4-01	Q4-00
Commercial and Industrial	114.0	110.9	109.4	118.0	110.4
Commercial Real Estate	462.3	385.9	439.5	384.9	224.9
<i>Construction & Development</i>	140.2	104.6	86.1	106.9	84.5
<i>Multifamily Residential Real Estate</i>	6.7	4.1	3.8	4.9	3.0
<i>Nonresidential Real Estate</i>	238.2	230.5	256.9	203.9	115.3
Residential Real Estate	89.1	76.4	81.3	66.7	56.7
Consumer	12.7	14.0	19.4	18.1	23.2
Agriculture	0.3	1.3	0.0	2.1	0.0

BANKING PROFILE

Largest Deposit Markets	Institutions in Market	Deposits (\$ millions)	Asset Distribution	Institutions
Phoenix-Mesa-Scottsdale, AZ	63	43,717	< \$250 mil.	37 (75.5%)
Tucson, AZ	19	8,941	\$250 mil. to \$1 bil.	7 (14.3%)
Prescott, AZ	11	2,472	\$1 bil. to \$10 bil.	4 (8.2%)
Yuma, AZ	9	1,111	> \$10 bil.	1 (2%)
Flagstaff, AZ	8	783		